BEFORE THE STATE BOARD OF EQUALIZATION

OF THE STATE OF CALIFORNIA

In the Matter of the Appeals of)
)
S. H. KRESS & CO.)

Appearances:

For Appellant: A. J, Oehler, formerly Controller of Appellant

For Respondent: Burl D. Lack, Chief Counsel; John S. Warren, Associate Tax Counsel

O P I N I O N

These appeals are made pursuant to Section 26077 of the Revenue and Taxation Code from the action of the Franchise Tax Board in denying the claims of S. H. Kress & Co, for refund of franchise tax in the amounts of $22,974.83, $7,721.58, $4,284.35, $27, 484.48 and $19,629.35 for the income years 1941, 1942, 1943, 1946 and 1947, respectively* and, pursuant to Section 25667 of the Revenue and Taxation Code, from the action of the Franchise Tax Board on the protests of S. H. Kress & Co. against proposed assessments of additional franchise tax in the amounts of $27,358.17, $49,066.61 and $48,335.34 for the income years 1948, 1949, and 1950, respectively, Appellant has paid the amount of the proposed assessments for the years 1948, 1949 and 1950 since the filing of its appeal. In accordance with Section 26078 of the Revenue and Taxation Code, the appeals for those years will also be treated as appeals from the denial of claims for refunds.

The Appellant, a New York corporation qualified to do business in California, operates a chain of retail variety stores in twenty-nine states and the Territory of Hawaii. As of December 31, 1951, forty-four stores were located in California and 215 stores were located elsewhere. This ratio prevailed generally during the years involved in these appeals. Except for relatively insignificant amounts received as interest, rentals, or from the occasional sale of real property, the Appellant's entire income is derived from buying and selling merchandise. It does no manufacturing or interstate retail business.

Each store has its own clerical staff, sales staff and manager, In making purchases, the store manager ordinarily indicates the merchandise and quantities desired but the order is placed with the vendor by central office buyers. The merchandise

is billed and shipped to the store by the vendor. Payment is made from the central office of Appellant and the store is charged at the manufacturer's invoice price less all discounts. Something less than 3% of the merchandise purchased by Appellant is warehoused and shipped at net cost to the store as it is required. Each store is charged with its own cost of doing business, including cost of merchandise, rent, depreciation, taxes, utilities, supplies and wages. The central office furnishes all executive, buying, accounting and supervisory services as required by the individual stores. The cost of services furnished by the central office is about three cents per dollar of sales and is prorated to each store as a general administration charge.

For the purpose of its franchise tax returns, Appellant has attributed its income to the various stores upon the basis of separate accounting. The Franchise Tax Board having determined that Appellant is conducting a unitary business, has allocated its income within and without the state upon the basis of the usual formula of property, payroll and sales in this State ascompared to those factors elsewhere. A comparison of net income as determined by Appellant's separate accounting and that as determined by Respondent is as follows:

Income Year	By Appellant	By Franchise Tax Board
1941	$1,356,913.77	$1,753,793.27
1942	2,338,142.23	2,738,856.50
1943	2,389,292.27	3,007,458.24
1946	2,819,583.20	3,497,276.06
1947	3,081,032.24	3,577,323.47
1948	3,026,682.69	3,840,556.26
1949	1,818,079.58	3,098,362.94
1950	2,462,466.06	3,593,603.06

The Appellant does not deny that its business is of a unitary nature but contends that, since its expenses in California are higher than elsewhere, the three factor formula as employed by the Franchise Tax Board attributes an excessive amount of income to this State. In particular, it points out that wages are at a higher rate in California than in other locations in which it operates. It suggests "that an apportionment be made upon the basis of the sales and property factors, applying the same against the income of the Company, before the deduction of salaries and wages, and then deducting therefrom the actual payroll and wages paid in California."

Section 24301 of the Revenue and Taxation Code (formerly Section 10 of the Bank and Corporation Franchise Tax Act) provides for allocation on a formula basis. The broad language

of the section indicates that the Franchise Tax Board is empowered in its discretion to choose a proper method for allocation, (El Dorado Oil Works v. McColgan, 34 Cal, 2d 731.) The use of the three factor Formula as here employed is recognized as a reasonable method of apportioning the income of a unitary business (Butler Bros. v. McColgan, 315 U.S. 501; Edison California Stores, Inc. v. McColgan, 30 Cal. 2d 472; El Dorado Oil Works v. McColgan, (supra); John Deere Plow Company v. Franchise Tax Board, 38 Cal. 2d 214, appeal dismissed 343 U.S. 939).

The Appellant "does not establish the unreasonableness of the formula allocation method by showing the reasonableness of its book entries. Its burden is to establish affirmatively that the formula equation produces an arbitrary and unreasonable result ... For taxation purposes the one does not impeach the other." Edison California Stores, Inc. v. McColgan, supra,

There is a striking similarity between the factual situation and contentions in this case and those considered in the Apeal of W. T. Grant Company decided December 15, 1948. There the formula was applied in the same manner. The Appellant relied on its separate accounting not only to show increased payroll costs in California but also increased costs in this State for rents, advertising, utilities, taxes, repairs and insurance. In our opinion in that case we stated that "The real point of inquiry, however, is not Appellant's per unit profit on sales in California, for it is not the net income from its California merchandising operations considered separately which we seek to ascertain. Appellant conducts a unitary enterprise and as such each of its units is a part of an integrated system. What we want to know is how its activities in California bear upon the success of the organization considered as a whole ... A local per unit loss, much less a lower per unit profit in local markets, is not inconsistent with improved net profits for the unitary business taken as a whole."

In concluding that the Respondent's application of the allocation formula is not arbitrary or unreasonable in this case, we need not rely alone on our decision in the W. T. Grant Company appeal, Subsequent to our ruling in that matter, the exact issue considered here was involved in John Deere Plow Company v. Franchise Tax Board, supra. In that case the plaintiff, who claimed the impropriety of the formula, argued the very point with respect to higher payroll costs in this State. The plaintiff referred to the fact that in the year 1937 "the San Francisco ratio was $6.76 in wages and salaries for each $100 of sales, whereas the average ratio for all included United States houses was $4.46." Relying upon ample citation

of earlier authority, the California Supreme Court rejected the contentions of the plaintiff. The Court held that the propriety of using the three-factor formula "in a given case does not require that the factors appropriately employed be equally productive in the taxing state as they are for the business as a whole. Varying conditions in the different states wherein the integrated parts of the whole business function must be expected to cause individual deviation from the national average of the factors in the formula equation, and yet the mutual dependency of the interrelated activities in furtherance of the entire business sustains the apportionment process."

One other problem has been presented by the Franchise Tax Board. For the income years 1942 and 1943 the Franchise Tax Board issued two notices of proposed assessment for each year, Appellant paid the amount specified in each of the original notices and filed suit for refund in the superior court as to each payment. Thereafter the Franchise Tax Board withdrew its original notices and issued another notice for each of the years. The proposed assessment for 1942 was greater, and that for 1943 was slightly less, than originally assessed and paid for those years. The Appellant paid the excess tax and interest for 1942 and interest for 1943. Those payments are the subject of the claims for refund for those years. Although the Franchise Tax Board has questioned where an appeal from the denial of those claims is properly taken to this Board, in view of our conclusion on the substantive issue it is unnecessary to examine this procedural question.

O R D E R

Pursuant to the views expressed in the opinion of the Board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to Section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of S. H. Kress & Co. for refund of franchise tax in the amounts of $22,974.83, $7,721.58, $4,284.35, $27,484.48, $19,629.35, $27,358.17, $49,066.61 and $48,335.34 for the income years 1941, 1942, 1943, 1946, 1947, 1948, 1949 and 1950, respectively, be and the same is hereby sustained.

Appeals of s. H, Kress & Co.

Done at Sacramento, California, this 8th day of December, 1955, by the State Board of Equalization.

J. H. Quinn, Chairman

Geo. R. Reilly, Member

Paul R. Leake, Member

Robert E. McDavid, Member

Robert C. Kirkwood, Member

ATTEST: Dixwell L, Pierce, Secretary